

SARSEP Checklist

DO NOT FILE WITH THE IRS.

Every year it is important to review the requirements for operating your Salary Reduction Simplified Employee Pension (SARSEP). This SARSEP Checklist has been designed as a quick tool to help you keep your SARSEP in compliance with important tax rules. This SARSEP Checklist is not a complete description of all the requirements and it is not a substitute for a comprehensive plan review.

Use of this SARSEP Checklist is voluntary.

	YES	NO
1. Was your SARSEP established prior to January 1, 1997 and subsequently amended for current law ? (No new SARSEPs can be established after 1996. SARSEPs should be updated to benefit from the new law.)	<input type="checkbox"/>	<input type="checkbox"/>
2. Do you have 25 or fewer eligible employees? (Only businesses with 25 or fewer eligible employees can contribute to a SARSEP.)	<input type="checkbox"/>	<input type="checkbox"/>
3. Are all employees who have attained age 21, worked for you in at least 3 of the last 5 years and have received at least \$450 in compensation included in the plan? (Employees of other businesses you and/or your family members own may have to be treated as employees in determining who is an eligible employee under this SEP.)	<input type="checkbox"/>	<input type="checkbox"/>
4. Have you notified participants of any changes in the SARSEP? (Participants must be given notice before changes go into effect.)	<input type="checkbox"/>	<input type="checkbox"/>
5. Are all employee elective deferrals within the appropriate limit : \$12,000 in 2003, \$13,000 for 2004? (If the employee is age 50 or over, an additional catch-up contribution up to \$2,000 can be made in 2003, \$3,000 in 2004.)	<input type="checkbox"/>	<input type="checkbox"/>
6. Do 50% or more of all eligible employees make employee deferrals? (At least half of your employees must make employee elective deferrals to the SARSEP.)	<input type="checkbox"/>	<input type="checkbox"/>
7. Are total contributions (employee elective deferrals and nonelective employer contributions) no more than 25% of compensation ? (For 2002 and 2003, contributions are limited to the lesser of 25% of compensation or \$40,000 adjusted annually for changes in the cost of living (\$41,000 for 2004). SARSEPs do not permit employers to make matching contributions to participants' accounts.)	<input type="checkbox"/>	<input type="checkbox"/>
8. Did you timely deposit employee elective deferrals? (Employee deferrals must be remitted to the appropriate financial institution as soon as possible but in any event, no later than 15 days following the month in which the employee would have otherwise received the money.)	<input type="checkbox"/>	<input type="checkbox"/>
9. Did you perform the annual average deferral percentage test ? (The amount deferred each year by each highly compensated employee as a percentage of pay (the deferral percentage) cannot exceed 125% of the average deferral percentage of all eligible nonhighly compensated employees.)	<input type="checkbox"/>	<input type="checkbox"/>
10. Have you made required top-heavy minimum contributions to the SARSEP? (Refer to your plan document for information. Most plans are deemed top-heavy, but some plans require annual testing.)	<input type="checkbox"/>	<input type="checkbox"/>

If you answered "No" to any of the above questions, you may have made a mistake in operating your SARSEP. Many mistakes can be corrected easily, without penalty and without notifying the IRS. We suggest that you contact your benefits professional. For more information, visit the IRS Retirement Plans web page at www.irs.gov/ep or call IRS TE/GE Customer Account Services toll-free at 1-877-829-5500.

SARSEP

A SARSEP is a simplified employee pension (SEP) plan set up before 1997 that includes a salary reduction arrangement. Under a SARSEP, employees can choose to have the employer contribute part of their pay to their Individual Retirement Accounts or Annuities (IRA). This contribution is called an “employee elective deferral” or “salary reduction contribution” because employees choose (elect) to set aside the money, and they defer the tax on the money until it is distributed to them.

In other words, it is the employees that decide whether and to what extent money will be paid to IRAs established for them under the SARSEP, rather than being paid to them as compensation. SARSEPs are similar in some respects to 401(k) cash or deferred arrangements.

A SARSEP is a written arrangement (a plan) that allows an employer to make contributions towards its employees' retirement without becoming involved in more complex retirement plans. A self-employed individual may also maintain a SARSEP. The contributions are made to traditional IRAs – not Roth or SIMPLE IRAs – of the plan participants. Under a SARSEP, IRAs are set up for each eligible employee.

1A. January 1, 1997:

The Small Business Job Protection Act of 1996 (SBJPA) prospectively repealed SARSEPs. Therefore, no new SARSEPs can be established after December 31, 1996. However, employers that established SARSEPs prior to January 1, 1997 can continue to maintain them, and new employees of the employer hired after December 31, 1996 can participate in the existing SARSEP. The introduction of SIMPLE IRA plans under IRC section 408(p) (added to the Code by SBJPA) is intended to fill the need for retirement plans like SARSEPs.

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1B. Current Law:

A SARSEP must be part of a written arrangement. As with regular SEPs, SARSEPs can be adopted using a model form, a prototype document or an individually designed document. Form 5305A-SEP is the model SARSEP issued by the Service. If a SARSEP is individually designed it must have language that satisfies IRC section 408(k)(6).

The Economic Growth & Tax Relief Reconciliation Act of 2001 (EGTRRA) changed many of the Code's requirements and limits for qualified plans and IRA's. In order to maintain tax-advantaged status and benefit under these new provisions, SARSEP prototype and individually designed plans must be amended for current law. In order for employers with model SARSEPs to maintain tax-advantaged status and to avail themselves of new law changes they must adopt the current version of the model Form 5305A-SEP. The current model [Form 5305A-SEP](#) has a revision date of March 2002.

The administrator of an amended SARSEP must furnish each participant – within 30 days of the amendment – a copy of the amendment and an explanation of its effects.

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2. 25 or fewer:

Salary reduction contributions cannot be made to a SARSEP for a year if there were more than 25 employees who were eligible to participate at any time during the preceding year.

The 25-employee rule is a look-back rule. It is a year-by-year rule. For example, if you had 23 eligible employees in year 2002, but 27 eligible employees in year 2003, salary reduction contributions may be made to the SEP-IRAs of the 27 employees for 2003. However, in year 2004, no salary reduction contributions may be made for you and your employees.

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3A. All Employees:

All eligible employees must be allowed to participate, including part-time employees, seasonal employees and employees who die or terminate employment during the year. An eligible employee is an employee who:

- Is at least 21 years of age.
- Has performed service for you in at least 3 of the immediately preceding 5 years.

The term “employee” includes a self-employed individual who has earned income.

Certain leased employees must be treated as “employees”.

Your SARSEP document can provide for less restrictive eligibility requirements (but not more restrictive ones). “Service” means any work performed for you for any period of time, however short. A SARSEP may not impose a length of service requirement.

Excludable employees: The following employees do not need to be covered under a SEP:

- Employees covered by a union agreement whose retirement benefits were bargained for in good faith by you and their union.
- Nonresident alien employees who did not earn U.S. source income from you.
- Employees who received less than \$450 in compensation during the year. This \$450 compensation limit is subject to [cost-of-living adjustments](#).

Example 1: Employer X maintains a calendar year SARSEP. Under the SARSEP, an employee must perform service in at least 3 of the immediately preceding 5 years, reach age 21, and earn the minimum amount of compensation during the current year. Employee A worked for Employer X during his summer breaks from school in 1998, 1999, and 2000 but never more than 34 days in any year. In July 2001, Employee A turns 21. In August 2001, Employee A begins working for Employer X on a full-time basis. Employee A is an eligible employee in 2001 because he has met the minimum age requirement, has worked for Employer X in 3 of the 5 preceding years, and has met the minimum compensation requirement for 2001.

Example 2: Employer Y designs its SARSEP to provide for immediate participation regardless of age, service or compensation. Employee B is age 18, and begins working part-time for Employer Y in 2000. Employee B is an eligible employee for 2000.

“Employee” under this SARSEP includes all employees of all corporations that are a member of a controlled group of corporations, trades or businesses under common control, or an affiliated service group. Service includes any work performed for any period of time for any other member of such group, trades or businesses. This means, for example, that if you and/or your family members own 80% of another business, employees of that business are “employees” for purposes of determining who is eligible to participate in this plan.

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4. Notice Requirements:

Disclosure to Employees:

- 1) The employer must furnish the following information to an eligible employee within a reasonable time after the later of the time of adoption of the SARSEP or the time the employee becomes employed.
 - a. Notice that the SARSEP has been adopted,
 - b. Requirements an employee must meet to receive an allocation, and
 - c. The basis upon which the employer's contributions will be allocated.
- 2) Failure to furnish the above information within a reasonable time subjects the employer to a \$50 penalty per failure, unless the failure is due to reasonable cause. See IRC section 6693(a).

Annual Statements:

Each year, the employer must furnish an annual statement to each employee participating in the SARSEP, showing the amount contributed to the employee's IRA for that year. Note: Often [Form 5498](#), IRA Contribution Information, is used for this purpose.

- 1) The annual statement for a calendar-year SARSEP must be furnished no later than January 31, following the calendar year for which the contribution is made, or, if later, 30 days after the contribution.
- 2) An employer who makes a contribution on behalf of an employee and fails to furnish an annual statement showing the amount contributed is liable for a \$ 50 penalty for each failure.

General Reporting Requirements:

In addition to the employee notice requirements above, the bank, insurance company or other trustee or issuer of the SEP-IRAs must comply with the following general reporting requirements.

- 1) [Form 5498](#) must be submitted to the Service by the trustee or issuer of a SEP-IRA to report contributions to the SEP-IRA. A separate Form 5498 must be submitted for each SEP participant.
- 2) [Form 1099-R](#), Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. is used to report distributions from a SEP-IRA. Distributions from a SEP-IRA are subject to the same automatic withholding rules that apply to distributions from other IRAs. See [Publication 590](#), Individual Retirement Arrangements, for details on IRA distribution rules.
- 3) SARSEP contributions by corporate employers are deducted on Form 1120. Employers who are sole proprietors may deduct contributions on Schedule C of Form 1040 and deduct contributions made for themselves on Form 1040. Partnerships deduct contributions made for common-law employees on Form 1065; but report on Schedule K-1 contributions made for partners, who deduct such contributions on their own returns.

SARSEP Notice and Reporting Requirements:

In addition to the notice and reporting requirements described above, SARSEPs have special notice and reporting requirements when the IRC section 408(k)(6) limits on elective deferrals are not satisfied. Notice 89-32 sets forth the reporting requirements in these situations. See Average Deferral Percentage Test below.

Form 5500:

The Form 5500 series forms that are required to be filed by most qualified retirement plans are generally not required for SARSEPs. SARSEPs are also generally exempt from the Department of Labor's reporting and disclosure requirements provided the employer satisfies certain employee notice requirements and does not impose investment restrictions on monies contributed to employees' IRAs.

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5A. Employee Elective Deferrals:

As in section 401(k) plans, contributions funded through salary reduction elections are called "elective deferrals" or "employee elective deferrals" because the contributions are made at the election of the employee and because the principal tax effect is to defer payment of income taxes until the money actually distributed to the employee from the SEP-IRA.

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5B. Appropriate limit:

Limit on Employee Elective Deferrals:

The most a participant can choose to defer for the 2003 calendar year is the lesser of:

- 1) 25% of the participant's compensation (limited to \$200,000), or
- 2) \$12,000.

The compensation limit in (1) is \$205,000 in 2004 subject to [cost-of-living adjustments](#) for later years. The amount in (2) increases to \$13,000 for 2004, \$14,000 for 2005, and \$15,000 for 2006 and later years. After 2006, the limit is subject to cost-of-living adjustments. The \$12,000 limit applies to the total employee elective deferrals the employee makes for the year to a SARSEP and any of the following:

- Cash or deferred arrangement (section 401(k) plan);
- Salary reduction arrangement under a tax-sheltered annuity plan (section 403(b) plan); or
- SIMPLE IRA plan.

Overall limit on SARSEP contributions:

The total of the nonelective and elective contributions for any participant cannot exceed the lesser of 25% of the employee's compensation or \$40,000 for 2003 (\$41,000 for 2004, subject to [cost-of-living adjustments](#) for later years). The same rule applies to contributions you make for yourself. For figuring the 25% limit on elective deferrals, compensation does not include SARSEP contributions, including elective deferrals or other amounts deferred in certain employee benefit plans.

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5C. Catch-up contributions:

In the case of an eligible employee who is 50 or older before the end of the calendar year, an additional amount of compensation ("catch-up elective deferral contributions") may be deferred during the year. The limit on catch-up employee elective deferral contributions is \$2,000 for 2003, \$3,000 for 2004, \$4,000 for 2005, and \$5,000 for 2006 and later years. After 2006, the limit is subject to cost-of-living adjustments.

Employee elective deferrals are not treated as catch-up contributions until they exceed the elective deferral limit (the lesser of 25% of compensation or \$12,000 for 2003 (\$13,000 for 2004), the SARSEP Average Deferral Percentage test limit discussed below, or the plan limit (if any). However, the catch-up contribution a participant can make for a year cannot exceed the lesser of the following amounts:

- The catch-up contribution limit.
- The excess of the participant's compensation over the employee elective deferrals that are not catch-up contributions.

Catch-up contributions are not subject to the elective deferral limit (the lesser of 25% of compensation or \$12,000 for 2003 (\$13,000 for 2004)).

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6. 50% or more of all Eligible Employees:

A SARSEP must be set up before 1997 and must meet the following requirements each year:

- 1) You must have 25 or fewer employees who were eligible to participate in the SARSEP in the preceding year;
- 2) At least 50% of your eligible employees must choose to make employee deferrals this year; and
- 3) The employee deferrals of your highly compensated employees meet the SARSEP deferral percentage limitation.

If fewer than 50% of your eligible employees choose to make employee deferrals to the SARSEP for a year, all employee deferrals made for that year are disallowed and must be withdrawn from the employees' SEP-IRAs. By March 15th of the following year, you must notify each affected employee of:

- 1) The amount of the disallowed deferrals to their SEP-IRA for the preceding calendar year,
- 2) The calendar year the disallowed deferrals and earnings are includible in gross income,
- 3) Information stating that the employee must withdraw the excess contributions (and earnings), and
- 4) An explanation of the tax consequences if the employee does not withdraw such amounts.

See the Instructions for [Form 5305A-SEP](#) for detailed information on correcting disallowed deferrals.

This is a year-by-year rule. Each year the 50% rule is not met, salary deferral contributions for that year cannot remain in the employees' SEP-IRAs.

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7A. Contributions:

The SARSEP rules permit you to contribute a limited amount of money each year to each employee's SEP-IRA. If you are self-employed, you can contribute to your own SEP-IRA. Contributions must be in the form of money (cash, check, or money order). You cannot contribute property, except in a rollover. See Publication 590 for more information about rollovers.

Depending on the terms of your SARSEP, you may be able to make nonelective contributions in addition to employee deferrals to the SEP-IRAs of your employees subject to an annual limit.

Once you make the SARSEP contribution, it is owned by the employee and cannot be made subject to a vesting schedule or taken back by you.

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7B. Compensation:

For years beginning after 2001, the maximum compensation used for figuring contributions and benefits is \$200,000. This amount is subject to [cost-of-living adjustments](#) after 2002. The limit is \$200,000 for 2002 and 2003, and \$205,000 for 2004.

Compensation will be defined in your SARSEP plan document. Compensation generally includes the pay a participant received from you for personal services for a year including:

- 1) Wages and salaries.
- 2) Fees for professional services.
- 3) Other amounts received (cash or non-cash) for personal services actually rendered by an employee, including, but not limited to, the following items.
 - a) Commissions and tips.
 - b) Fringe benefits.
 - c) Bonuses.

Compensation of self-employed individuals. If you are self-employed, compensation is your earned income as defined below. Compensation does not include tax-free items (or deductions related to them) other than foreign earned income and foreign housing cost amounts.

Earned income. Earned income is net earnings from self-employment from a business in which your services materially helped to produce the income. You can also have earned income from property your personal efforts helped create, such as royalties from your books or inventions. Earned income includes net earnings from selling or otherwise disposing of the property, but it does not include capital gains. It includes income from licensing the use of property other than goodwill. Earned income includes amounts received for services by self-employed members of recognized religious sects opposed to social security benefits who are exempt from self-employment tax.

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7C. Lesser of 25% of compensation or \$40,000:

The annual contribution limit is the lesser of 100% of the employee's compensation limited to \$200,000 for 2003 (\$205,000 for 2004, and subject to [cost-of-living adjustments](#) for later years) or \$40,000 for 2003, (\$41,000 for 2004 and subject to [cost-of-living adjustments](#) for later years). In determining this limit, you must include the amounts deferred by the employee and the nonelective contributions you make to the SEP-IRA. In addition, contributions made on behalf of an employee to another defined contribution plan you sponsor must be included for purposes of the annual contribution limit. The same rule applies to contributions you make to your own SEP-IRA.

The most you may deduct on your business tax return for your contributions to your employees' SEP-IRAs is the lesser of your contributions or 25% of compensation. For this purpose, compensation is limited to \$200,000. Employee elective deferrals are not subject to the 25% of compensation limit. If you are self-maximum deduction for these contributions. When figuring the deduction for contributions made to your SEP-IRA, compensation is your net earnings from self-employment which takes into account the following deductions; (a) the deduction for one-half of your self-employment tax and (b) the deduction for contributions to your own SEP-IRA. See [Publication 560](#) for details on determining your deduction. If your SARSEP plan document specifies lower contribution limits, then the lower limits control.

Matching contributions are not permitted in a SARSEP.

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8. Timely Deposit:

You must forward employee contributions to the financial institution as soon as they can be reasonably segregated from the employer's general assets, but in no event later than 15 days following the month they were withheld from the employee's paycheck. See Department of Labor Regulation Section 2510-3-102.

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9. Average Deferral Percentage Test:

SARSEPs are subject to a nondiscrimination test similar to the annual test imposed on section 401(k) plans. This test limits the amount your highly compensated employees can defer based on what your nonhighly compensated employees defer. The deferral percentage limit for your highly compensated employees is computed by first averaging the deferral percentages for the nonhighly compensated employees for the year and then multiplying this result by 1.25. The deferral percentage limitation must be computed each year. See the Instructions for [Form 5305A-SEP](#) for this computation.

The deferral percentage test for SARSEPs compares the deferral percentage of each HCE with the average of the deferral percentages of all other employees – not the average of the deferral percentages of all HCEs with the average of all other employees (as in a 401(k) plan). Further, unlike section 401(k) plans, nonelective contributions from the employer cannot be used to help the SARSEP satisfy the annual test.

If an employee who elects to defer compensation under the SARSEP has exceeded the deferral percentage limit for a year, the employee must withdraw those excess contributions by April 15 following the calendar year in which the employee is notified. Excess contributions not withdrawn by April 15 will be subject to the IRA contribution limits of sections 219 and 408 and may be considered excess contributions to the employee's IRA. For the employee, these excess contributions are subject to a 6% tax on excess contributions under section 4973. Income on excess elective deferrals is includible in the employee's income in the year it is withdrawn from the IRA. The income must also be withdrawn by April 15 following the calendar year of notification. If the income is withdrawn after that date and the recipient is not 59 ½ years of age, it may be subject to the 10% tax on early distributions under section 72(t).

If the deferral percentage limitation is exceeded, you must notify each affected employee by March 15th of the following year of:

- 1) The amount of the excess contributions to their SEP-IRA for the preceding calendar year,
- 2) The calendar year the excess contributions and earnings are includible in gross income,
- 3) Information stating that the employee must withdraw the excess contributions (and earnings), and
- 4) An explanation of the tax consequences if the employee does not withdraw such amounts.

See the Instructions for [Form 5305A-SEP](#) for a detailed description of the notification procedures.

Highly compensated employee. A highly compensated employee is an individual who:

- Owned more than 5% of the capital or profits in your business at any time during the year or the preceding year, or
- For the preceding year, received compensation from you of more than \$90,000 and, if you so choose, was in the top 20% of employees when ranked by compensation. The \$90,000 amount in the preceding sentence is the amount applicable to years 2002 through 2004.

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10. Top Heavy Minimum:

A SARSEP is top-heavy when more than 60% of all employer contributions go to key employees. But since many SARSEPs are always top-heavy, SARSEPs are often drafted to operate as if they were always top-heavy, thereby eliminating the need to make the annual 60% determination.

For purposes of determining if a plan is top-heavy, employee elective deferrals are considered employer contributions. Employee elective deferrals may not be used, however, to satisfy the minimum contribution requirements for top-heavy plans. For purposes of determining the top-heavy minimum contribution, all employee elective deferrals made by key employees must be counted, but no employee elective deferrals made by non-key employees are counted towards satisfying the minimum contribution.

The employer will satisfy the top-heavy requirements by making a minimum contribution each year to the SEP-IRA of each employee eligible to participate in this SARSEP. This minimum contribution is not required for key employees. This contribution, in combination with other nonelective contributions, is equal to the lesser of:

- 3% of each eligible non-key employee's compensation or
- The percentage of compensation at which elective (not including catch-up elective deferral contributions) and nonelective contributions are made under this SARSEP (and any other SEP maintained by the employer) for the year for the key employee with the highest percentage for the year.

A key employee is any employee who, at any time during the preceding year was:

- An officer of the employer with compensation greater than \$130,000;
- A 5% owner of the employer, as defined in section 416(i)(1)(B)(i) of the Internal Revenue Code; or
- A 1% owner of the employer with compensation greater than \$150,000.

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